ANNEX A to Letter to The Secretary of State from the Government Appointed Members of the Horserace Betting Levy Board dated 30th November 2010

THE 50TH LEVY SCHEME

SUBMISSION OF BRITISH HORSERACING

1 EXECUTIVE SUMMARY

A. Overview

"The horserace betting Levy system was introduced in 1961. It is a mechanism for transferring funds from the business of betting on horseraces to "horseracing" in a broad sense" (Home Office, 1999).

That remains the case today and Racing welcomes the new process heralded by the Levy Board's letter to the Secretary of State in April 2009 to arrive at what the amount should be. That amount has to be reasonable, and Racing is committed to a process of negotiation, overseen by the Levy Board Independents, to arrive at that reasonable amount. Racing's goal is simply this: to establish a reasonable yield to Racing from the Levy for the 50th Scheme. This submission sets out Racing's assessment of what would amount to a reasonable yield.

Once that amount is established, which we consider is best seen as a range, Racing is committed to working with the Levy Board and Betting to establish a Scheme which is designed to have a good prospect of achieving it as a "target yield".

Under the new process, "any matter that is relevant in the circumstances at [the] time…should be taken into account."

This is a task that we believe requires an evidence based approach based on rigorous analysis, and the few "fixed points" that exist over the history of the Levy. We have adopted a number of different approaches:

- An approach which considers Racing's reasonable needs, the Betting industry's reasonable capacity to pay and the wider economic, fiscal and social circumstances as may relate to Betting and Racing;
- An approach based on generally accepted economic theory and detailed analysis of the financial returns from fixtures, whilst also taking into account racecourses' financial performance and the level of contributions emanating from racehorse owners.

We have adopted a conservative approach throughout.

We have also analysed international comparisons between Britain and other major racing nations as a validating exercise, and to compare with the returns from Betting to Racing deemed to be 'reasonable' in other major racing nations.

Taking into account all relevant circumstances, Racing believes that the reasonable return from Betting in the course of the 50th Scheme should be between **£130m** and **£150m**.

B. Funding of Racing

The table below illustrates how the funding structure of Racing has shifted since the early 2000's, including a reduction in the relative contribution of the Betting industry in contrast to the much higher payments from owners and Racing's other consumers (i.e. racegoers, non-betting media rights customers and sponsors etc.).

In this report we draw analogies between now and 2002, this being the year in which the Secretary of State last determined what range of values would represent a reasonable return.

The c.25% fixture expansion which has occurred since 2002 has been largely funded by Racing's participants, despite being, in large part, driven by the requirements of the Betting industry. With the majority of the additional fixtures being staged at All Weather racecourses, the fixture expansion has been achieved using the most efficient means available to Racing.

Financial contribution to British Racing - 2002, 2005 and 2008

Group	2002 £m	%	2005 £m	%	2008 £m	%	Growth 2002-08 £m
Betting industry	120	19%	152	17%	160	15%	40
Racing consumers	197	31%	301	35%	404	39%	207
Owners - net training costs	125	20%	200	23%	275	26%	150
Owners - breeding operations costs	191	30%	217	25%	207	20%	16
Total	**633**		**870**		**1046**		

Source: Economic Impact of British Racing (2006 and 2009 Deloitte reports); KPMG; BHA estimates

- The most striking aspect of the split of expenditure is the very substantial increase in contribution to British Racing of owners. Net training fees alone are estimated to have grown by £150m between 2002 and 2008, as a consequence of higher training costs and, importantly, marked falls in real terms in average prize money levels. These higher training costs are largely reflecting higher costs of goods and services, and do not reflect an internal "profit".
- Betting's contribution represents payments to the Levy, LBO picture rights and race sponsorship payments.
- For many class of races, the actual prize money being offered in 2010 is below that offered for the same races in 2002, which is both unfair and also importantly acts as a major deterrent for existing owners to stay in the sport, and to new owners to enter the sport.
- When combined with the costs of breeding horses (which owners typically bear through horse purchases) investment from owners totalled almost £500m in 2008.
- The majority of this expenditure is injected into the rural economy and is vital in supporting tens of thousands of jobs. Prize money is also distributed to trainers and their staff, so it is not only an indirect factor in encouraging or discouraging owners, it also has a direct impact on pay levels for the workforce.
- The majority of Racing consumer spending is at racecourses. However, the substantial associated costs mean that racecourses' profits remain at modest levels. Aggregate racecourse profits in 2008 were substantially lower than in 2002.
- Racecourses' profits are estimated to have declined by a further 5-10% in 2009 and the outlook for 2010 and 2011 remains challenging. We have taken full account of all racecourse income streams. Increased returns from media rights contracts for LBO pictures already

negotiated are believed not to apply until 2012 fixtures at the earliest, and hence are largely not relevant in the 50th Levy Scheme consideration.

- The proportion of Racing's funding which comes from the Betting industry has declined from 19% in 2002, to 15% in 2008 and is almost certain to have fallen further in 2009. This is despite the Betting industry's much enhanced capacity to pay.

C. Betting's Increased Capacity to Pay

- The Betting industry has experienced a period of sustained and rapid growth driven by deregulation, product diversification and the introduction of gross profits tax. By illustration the pre tax and interest profits of the "Big 3" Betting operators (William Hill, Ladbrokes and Coral) increased from less than £250m to over £750m between 2001 and 2008.
- The recession has seen declines in profits in 2009, but profit levels are still markedly higher than in 2002, and the Betting industry's confidence in the medium term health of the market is seen in the continued investment they are making.
- British Racing remains by some margin the largest sport for British betting operators. Since 2003/04 the Betting industry's gross win from British Racing has consistently been over £1bn, reaching a high of £1.2bn in 2007/08.
- The decline in the gross win from British Racing since 2007/08, and hence payments to Racing through the Levy, is a reflection of major structural defects of recent Levy schemes. Betting on Racing remains as popular as ever but significant leakages have occurred through exchanges and offshoring amongst other factors. The termination of Levy contributions from betting on all racing in LBOs has a negative impact. The continued existence of LBO thresholds under a gross profits Levy regime has also unfairly reduced the amount of Levy.
- British Racing has consistently met the Betting industry's need for additional product by expanding the fixture list and in slots to suit the Betting industry, notably winter evenings. Whilst the betting opportunities provided by the additional fixtures are intended to increase betting operation profits on Racing, it is clear the fixtures are also intended to increase profits on other products available in betting shops, particularly FOBTs/gaming machines. Racing does not benefit from these profits but bears the full cost of the expansion. Furthermore, the development and promotion of these other products has deflected betting away from Racing.

D. Quantifying a reasonable return and target Levy yield

In seeking to assess a reasonable return, taking into account all relevant factors, we have considered various methodologies, with a range emanating from each of these approaches as follows:

REASONABLE LEVY YIELDS		
	Method	**2011/12 reasonable return**
1.	**Racing's Needs** A cost focused approach based on conservative estimate of the incremental costs to Racing since the 2002 Determination of a reasonable range of £90-£105m.	£133-152m
2.	**Reasonable Share of Benefits** Starting with the 2002 Determination, consider a fair apportionment of the benefits of the substantial fixture expansion between Racing and Betting.	£128-149m
3.	**Market approach** An economic model which mirrors negotiations widely used for specialised assets for which there are unique users and suppliers.	£121-151m (£154-184m including convoyed sales)
Result	**Reasonable Levy Yield**	**£130-150m**

Based on these approaches, and validated by the international comparisons set out in section 4, we believe that the reasonable return from Betting in the course of the 50th Scheme is between **£130m** and **£150m**.

E. Racing's Needs Approach

- Our first approach starts with the 2002 Determination, this being the last time a comprehensive determination concluded what a reasonable return should be. In reaching her decision the then Secretary of State, Tessa Jowell, considered it reasonable that the 2002/03 Levy amount should be in the £90-105m range.
- While a Determination of the 47th Levy Scheme did of course take place in 2007/08, the result was not the setting of a new Scheme, but a rollover of existing arrangements to be accompanied by a full review of a number of issues surrounding the Levy, and a modernisation of its processes. The modernisation that has led to the new timetable and Racing submitting its proposals first will allow for many of the largely unresolved issues to be dealt with in the forthcoming negotiations.
- In this approach, we take the £90-105m range and evaluate how Racing's Needs have increased since 2002/03 by considering the impact of inflation, fixture expansion and related costs and demands on racecourses/central funding and the horsemen. The table below summarises the results of each of these factors.

Racing's Needs

£'m	Lower	Upper
2002/03 target yield	90.0	105.0
Less 2002/03 integrity costs	(16.2)	(16.2)
2002/03 target yield excluding integrity	73.8	88.8
Current integrity costs (2009/10)	25.0	25.0
Additional Fixtures		
Racecourse losses (1)	5.5	5.5
Owners' transport costs	6.5	6.5
Inflation (2)	22.2	26.3
TOTAL	**133.0**	**152.1**

Notes:

(1) Includes an estimated £4m of additional overheads and a requirement for reasonable return on capital. Excludes integrity costs of extra fixtures to avoid double counting

(2) Actual RPI to 2010 has been applied to the 2002/03 target yield (excluding integrity), thereafter forecast inflation has applied to all costs

Source: BHA analysis

Racing has experienced significant inflation since 2002/03

- Many of Racing's largest costs such as utilities, transport, equine costs etc, have experienced high inflation rates over the period. We have taken a conservative approach by using RPI which in aggregate was 25% between 2002/03-2009/10. We have used the general economic consensus on forecast inflation rates to adjust upwards to 2011/12.

The continued standards of regulation and integrity of British Racing is paramount but has an associated cost

- Centrally funded regulatory and integrity costs (including the provision of raceday officials, a comprehensive programme of Equine Welfare, doping control, an integrity services team, a comprehensive head office function to deal with the licensing of the sports participants and all racecourses, and disciplinary processes enforcing the Rules of Racing) have increased from £16.2m in 2002/03 to £25m in 2009/10. This is primarily as a consequence of the substantial fixture expansion and the increasingly complex betting environment in which Racing operates (including the emergence of betting exchanges).
- Operational efficiencies in regulation and integrity provision have been introduced by the industry, which have reduced the cost per fixture, and Racing continues to work to introduce further efficiencies wherever possible. However, as is generally accepted within the Levy Board's own policy objectives and across Government, there can be no compromise from the existing highest standards of regulation and integrity. Hence the scope for significant further cost reductions is limited.

The Betting industry must contribute reasonably to Racing's costs of fixture expansion

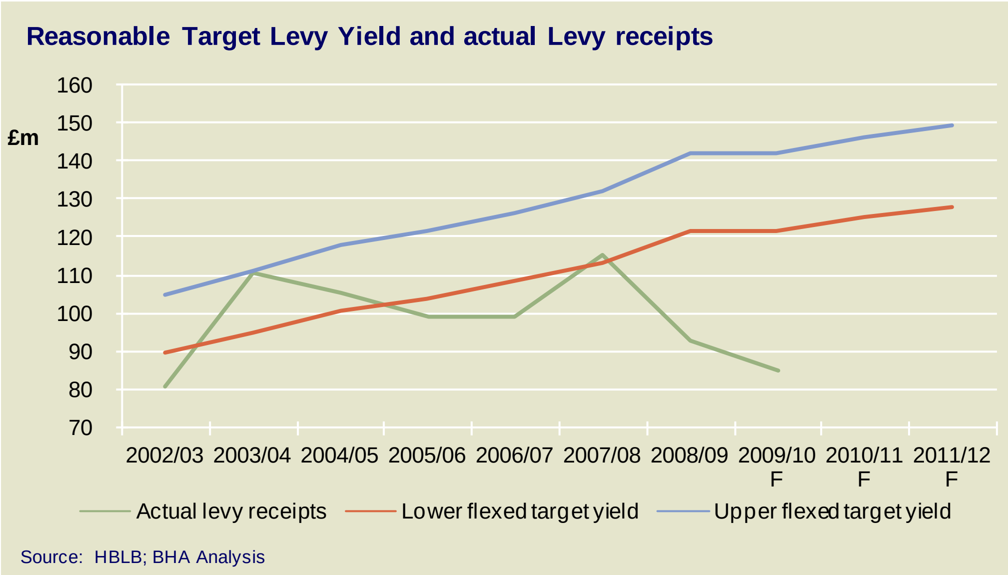
- In order to establish the minimum payment that is required from the Betting industry through the Levy for Racing to put on the additional fixtures, put on at Betting's request, namely BHA leasehold fixtures, we have considered racecourses' raceday losses, excluding all amounts paid to the racecourse by the Levy Board. By excluding these amounts but giving full credit for other revenues including LBO picture payments, we arrive at a loss before central support. It is reasonable to expect Betting, through the Levy, to at least make good the losses arising from these fixtures.
- Our analysis estimates that this pre Levy support raceday loss is £6m for the 2009 leasehold fixtures.
- In addition we conservatively estimate that the additional overheads created, forgone non-raceday revenue and the incorporation of a fair, but modest, return from these fixtures results in a further £4m funding requirement.
- We have deducted the £4.5m integrity costs (funded by the Levy) from this total to remove double counting, which results in a net cost of these additional fixtures of £5.5m.

Owners' costs - a modest but fair funding solution that will benefit all parties

- We have already highlighted the £150m increase in net owners' expenditure on training costs since 2002. The expansion of the fixture list has been an important factor. However, for this methodology we have only considered the most direct cost, namely transport costs, incurred by owners to bring their horses to these additional fixtures.
- We propose owners' estimated transport costs of £6.5m for these additional fixtures should be funded through an increased Levy yield. The use of this funding will help rebalance the current unsustainable cost versus reward equation.

F. Reasonable Share of Benefit – a fair apportionment of the benefits of fixture expansion

- This approach is related to the Racing's Needs approach in that it starts with the 2002 Determination's specified range and adjusts for inflation.
- It differs in that rather than purely focusing on Racing's incremental costs it considers a fair apportionment of the benefits of the substantial fixture expansion between the Racing and Betting industries.
- Our methodology recognises that there is not a linear relationship between the increase in the size of the fixture list and total betting turnover on British Racing, primarily due to the substitution effect (being punters transferring some of their stakes on existing Racing to new additional fixtures) which we have conservatively estimated as 50%. In practice we consider it likely to be significantly lower than 50%, particularly given the establishment of many fixtures in new time slots.



- The chart above shows the result of the 2002/03 range adjusted for inflation and additional fixtures, together with the actual Levy receipts to 2008/09 (and forecast for 2009/10). It illustrates how that in real terms successive Levy schemes since 2004/05 have failed to generate sufficient Levy receipts to keep pace with even the lower limit of the specified range of the 41st Scheme.
- This approach illustrates that while it is recognised the reasonable Levy yield for 2011/12 represents a substantial uplift from current levels, this is due to Racing receiving amounts considerably below what it should have on a reasonable basis for many years.

G. Market Approach

This approach provides a generally accepted test of what a reasonable return should be in the operation of a market. We have therefore carried out an analysis based on general economic theory employed in negotiations and valuation exercises for the purposes of tribunals etc, to consider how the Levy might be determined in a market context. The model mirrors negotiations widely used for specialised assets, often involving intellectual property, for which there are unique users and suppliers.

In this approach, parties are taken to enter hypothetical negotiations and make initial offers of the maximum or minimum Levy prices they could possibly accept. They negotiate an agreed Levy price within this price range, depending on their relative bargaining power, needs and capacities. The key features of the model include:

- The "upper bound" of the range would be the maximum Levy that Betting might be prepared to pay for access to Racing for Betting purposes. It represents the profits betting would lose if British Racing was withdrawn.
- The "lower bound" of the range is the minimum Levy that Racing might be prepared to accept to supply an acceptable quantity and quality of Racing product. The lower bound has been derived from an analysis of how many leasehold fixtures would be withdrawn by Racing given step reductions in the headline Levy rate, and how low the Levy could be reduced before

Betting's lost profits from the withdrawn fixtures exceed its Levy savings on the remaining fixtures.

- These extreme "walk away" positions define the bounds of the negotiations.
- The analysis computes a price between the two extremes where the parties might agree to share the "surplus" (the difference between the upper and lower bounds), depending on their relative bargaining strength and other considerations.
- Having calculated the upper and lower bounds, it is conservatively assumed that Racing retains only 25% of the difference (which might actually be higher in commercial situations).

The economic model estimates that a negotiation would likely result in an agreed price of £121-151m, excluding the impact of "convoyed sales".

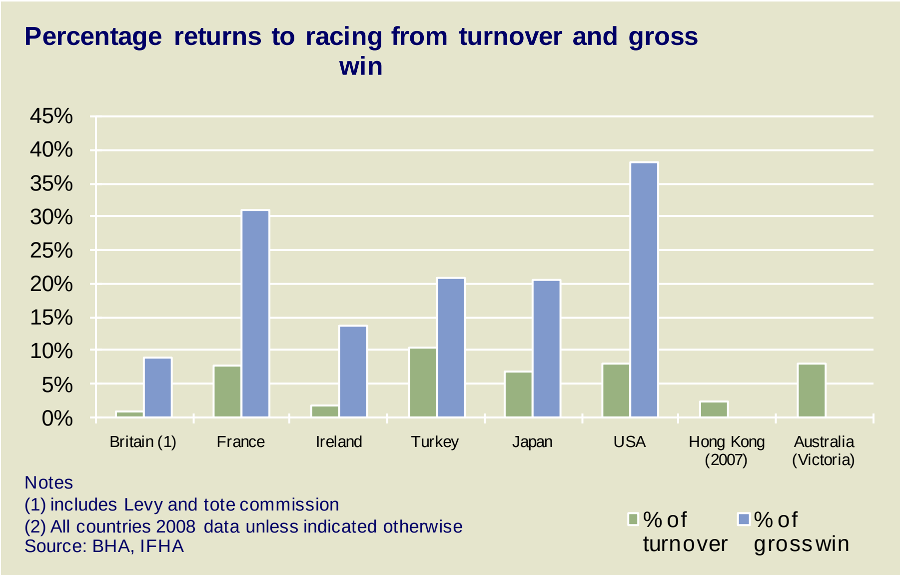
The "convoyed sales" aspect recognises that Racing contributes to the sales of other products in the LBOs, notably FOBTs. When LBO earnings from "convoyed" sales are added this increases the range to £154-184m.

H. International comparisons starkly illustrate the chronic underfunding of British Racing by Betting

Even in countries where there is a cultural, social and legal antipathy towards betting, Racing and the economic and social good that it creates, particularly in the rural sector is recognised, as is its inherent value as a betting product. Systems have therefore been put in place to enable Racing to be funded by Betting.

International comparisons validate the results of our previous methodologies, as showing that levels of funding in Britain, which has developed the most liberal approach to betting and gaming, are not at reasonable levels. It also shows that the returns from Betting to Racing deemed as reasonable in other major racing nations far exceed the return to British Racing via the current Levy mechanism:

- The equivalent to 1% of betting turnover paid to Racing in Britain compares to a more typical range of 8-12%.
- The 10% levy on gross profits on British Racing is again significantly less than in other countries which typically have returns in the 20-35% range.



This shows British Racing is at a serious disadvantage, as further evidenced by increasing numbers of owners relocating their horses overseas. As horseracing becomes increasingly global, this position threatens the long term health of the Racing industry in this country.

I. Options by which the 50th Scheme can deliver a reasonable return

It is not the purpose of this submission to propose the detailed design of the 50th Levy Scheme to achieve what is considered to be the reasonable return, and therefore a target Levy yield. The design of the Scheme must follow after the reasonable return has been established. Indeed, it is a matter for the Bookmakers' Committee to propose and the Levy Board to agree a Scheme that will deliver a reasonable yield to Racing, particularly bearing in mind the fact that Racing does not have the detailed information on which to make detailed proposals.

However, in considering the Scheme's design, we believe both the Bookmakers' Committee and the Board should take into account the various structural deficiencies that exist within the current Scheme.

The suggestions listed below are not intended to be exhaustive:

- **Overseas horseracing** - in our view, the Levy on overseas horseracing should properly now be reintroduced for the 50th Scheme. There is nothing in the Levy legislation which limits the Levy to revenues in relation to British horseracing and, indeed, there is clear historical precedent for our position.
- **Thresholds -** are a historical anomaly and we suggest they are removed from the 50th Scheme. In principle, there is no proper place for a Thresholds System in any Scheme where LBO contributions are calculated by reference to gross profit. However, provided that a reasonable return is established and a Scheme designed to target this yield, Racing would fully support initiatives within Betting to establish relief from Levy payments to the very smallest operators who run just a handful of LBOs if this were to encourage and protect consumer choice.

- **Betting on exchanges -** we consider there are two key issues that need to be considered in relation to Betting Exchanges for the 50th Scheme to determine how the exchanges pay a fair return to Racing, through the Levy:
  - Firstly, whilst betting exchanges and traditional bookmakers are “bookmakers” for Levy purposes, they perform very different roles and derive their income from betting on Racing in different ways, and there is, therefore, no reason why they should be subject to the same treatment within the Levy Scheme.
  - Secondly, it seems certain that there are many exchange customers who are acting as "bookmakers" within the Levy legislation and, therefore, have an obligation to pay the Levy as such under both the 48th and 49th Schemes. Any design of the 50th Scheme should facilitate the efficient collection of Levy from these individuals.
- **Offshoring -** the Levy was designed to capture all British betting activity on Racing; the fact that some companies have set up telephone call centres or websites offshore to carry out the same activity should not alter their obligation to pay the Levy.
- **“Relates to” Test –** Racing is entitled to receive the Levy in respect of any area of betting operator business that “relates to betting” on horseracing. This means that Racing should be entitled to receive a level of return referable to FOBTs, ‘Virtual Racing’, and other revenue streams where that revenue can reasonably be said to “relate to”. We believe the Levy Board should request specific information from Betting that would quantify such relationships.